INDIVIDUAL

The insolvency safe harbour

The *Corporations Act 2001 (Cth)* (Corporations Act) provides directors with a protection from civil insolvent trading liability in certain circumstances.

Ordinarily, pursuant to the insolvent trading provisions in s 588G(2) of the Corporations Act, company directors will be personally liable for certain debts which are incurred if:

- they are a director at the time when the company incurs the debt;
- the company is insolvent at that time, or becomes insolvent by incurring that debt; and
- at that time, there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.

However, the safe harbour provisions in s 588GA of the Corporations Act essentially provide directors with a form of defence or exception to this provision in some circumstances.

Section 588GA(1) excludes liability for insolvent trading if:

- at a particular time after a person starts to suspect a company may become or be insolvent, he or she starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
- the debt is incurred directly or indirectly in connection with that course of action and during a specified time period.

The purpose of this legislation is to "drive cultural change amongst company directors by encouraging them to keep control of their company, engage early with possible insolvency and take reasonable risks to facilitate the company's recovery."[1]

This director tool contains suggested steps for pursuing a restructuring plan and attempting to trigger the safe harbour protection for insolvent trading provided in s 588GA(1) of the *Corporations Act 2001* (Cth).

Please note that these steps are intended to be a broad guide only and should not be interpreted as an exhaustive list for directors attempting to use the safe harbour protections, or as a supplement for legal advice.

1. Explanatory Memorandum, General outline and financial impact, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), **https://www.legislation.gov.au/Details/C2017B00100/Explanatory%20Memorandum/Text**, (accessed 14 September 2020).

Key steps to trigger safe harbour protection

While further detail and analysis is contained below, this flow chart summary presents the key steps directors should consider in order to access the safe harbour protection in s 588GA(1).

1. Check that any outstanding employee entitlements are paid and ensure that the company will be able to continue to pay employee entitlements by the time they fall due.

2. Check that the company is meeting all its tax reporting obligations and ensure that systems are put in place to enable the company to continue meeting these obligations.

3. Check that there are no outstanding issues relating to misconduct of employees and officers that needs to be resolved. Directors should focus on ensuring employees are complying with company policies and misconduct should be identified and dealt with appropriately.

4. Check existing insurance and indemnity policies, including D&O insurance, is up-to-date and adequate, and notification requirements

5. Before incurring any further company debt, consider making an initial assessment regarding whether it will lead to a better outcome for the company to immediately appoint an administrator or liquidator. At this stage, directors should consider obtaining advice from an appropriately qualified entity and ensure that the entity was given all the information required to provide advice regarding the company's prospects.

6. If the initial assessment and advice points to the likelihood of a better outcome for the company than the immediate appointment of an administrator or liquidator, directors should consider developing a restructuring plan in earnest. Directors should consider making arrangements to also ensure that relevant documents are recorded carefully and archived.

7. Consider placing the following items on the agenda of the board as 'standing' items for consideration and discussion:
   a. the adequacy of financial records and how these financial records might be improved;
   b. the financial position of the company, and whether it has deteriorated or improved, and how this might impact the availability of the safe harbour;
   c. whether further advice needs to be obtained from an appropriately qualified entity;
   d. whether the restructuring plan is being implemented, and whether adjustments will be required to ensure that the desired outcome will be achieved; and
   e. whether, all things considered, it would be better for the company to immediately appoint an administrator or liquidator.

8. When implementing a restructuring plan, directors should continually assess whether their chosen course of action will still lead to a better outcome for the company to pursue the restructure, when compared with the immediate appointment of an administrator or liquidator. Where necessary, directors should obtain new advice from an appropriately qualified professional regarding these steps.

9. If the company is placed into formal insolvency, directors should ensure compliance with any obligations relating to the provision of books and information to a liquidator, administrator or controller. In addition, directors should ensure they are compliant with their obligations to provide assistance to a liquidator, administrator, or controller.

Who is eligible?

From the outset, directors should consider the prospect of insolvency and financial distress at board level rather than at individual level. Directors should bear in mind that their common law and statutory duties are to the company itself, and not to themselves.

For this reason, gaining the protection of the safe harbour for themselves cannot be the main focus of directors. Instead, directors must consider first and foremost the interests of the company itself, and what will be required to promote the company's interests. The purpose of the safe harbour is to empower directors to take actions which will promote the company's interests by protecting them from personal liability.

Once directors are aware the company is in financial distress and insolvency is approaching, it is in their interest to begin considering measures which need to be put in place to ensure that the safe harbour protection can be relied upon in later proceedings at the earliest opportunity. They should take some form of action to ascertain the extent of the company's difficulties. In some circumstances, this may require them to commission or undertake an audit of the company's solvency. In particular, if a company is in financial distress, directors should seek to delay or defer the taking on of any further debts until the directors are satisfied that they have considered the need for safe harbour protections.

Taking early and appropriate action to deal with a company's financial difficulties will put the board in the best position to turn a company around and avoid administration and liquidation, as well as to trigger safe harbour protection, should that be necessary.

Timing is important

The safe harbour only starts to apply from the time the director, after beginning to suspect that the company may become insolvent, starts developing one or more courses of action, and one of those courses of action is reasonably likely to lead to a better outcome for the company that the immediate appointment of an administrator or liquidator.

However, the time taken between considering what should be done and actually going ahead and doing it is not limitless, and the safe harbour will only protect directors during a reasonable period between the consideration of the various courses of action and their implementation. The Explanatory Memorandum notes that the duration of the reasonable period will vary on a case-by-case basis.

This suggests that directors can be protected by the safe harbour even if their course of action has not been put into action but is still in a planning or development phase. Indeed, the directors may wish to consider a variety of potential options for the company's future.

However, the Explanatory Memorandum notes that directors should move promptly and decisively towards implementing a suitable course of action (or entering the company into formal insolvency) as is responsible in the circumstances.

Frequently asked questions

When insolvency is suspected, what should I do first?

Once insolvency is suspected, directors should take positive steps towards developing a course of action for the company that is reasonably likely to lead to a better outcome, or alternatively, immediately appointing an administrator or liquidator.

To determine whether to appoint an administrator or liquidator or embark on a course of action, some of the steps that directors may be required to undertake are as follows:

- Properly inform yourself of the company's financial position by, for instance, engaging an auditor to assess the company's solvency.
- Take measures to ensure that the company is keeping appropriate financial records. This may, for instance, involve the board examining current management processes with a critical eye. The maintenance of appropriate records is important if directors will rely on the safe harbour in legal proceedings.
- Obtain advice from one or more appropriately qualified entities regarding the company's restructuring options, financial position, and legal exposure. In particular, directors should look to obtain an advice which considers potential courses of action and compares them with the result that follow from the immediate appointment of an administrator or liquidator.
- Assess whether the company will continue to be in a position to meet all payments to employees on time, or whether this will prove impossible. If impossible, directors will not be able to rely on the safe harbour protections.
- Assess whether there is any employee fraud, theft, or other misconduct of employees, and addressing it immediately. The continued presence of employee misconduct may jeopardise the protection of the safe harbour.

What is a 'better outcome'?

The protection of safe harbour is contingent on directors developing and implementing a course of action that will lead to a better outcome for the company, and the term 'better outcome' is defined in comparative terms: a better outcome for the company is one that will be 'better' for the company than 'the immediate appointment of an administrator or liquidator'.

Directors are given a significant degree of latitude regarding the kind of action that they can take, provided it is reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or liquidator. This flexibility recognises that not all restructuring attempts will be successful, and that administration or liquidation may occur despite the attempt.[2]

Bearing in mind their duty to act in good faith in the best interests of the company, and having regard for creditors, directors may consider the following questions when assessing whether to pursue a course of action, or to immediately appoint an administrator or liquidator:

- Will a delay or deferral of administration or liquidation be likely to result in a better return to shareholders and creditors?
- Will the immediate appointment of an administrator or liquidator result in a reduction of the company's assets, including its goodwill? Will a delay or deferral make any meaningful difference to the end result?
- Are the company's financial difficulties the result of a short-term issue? Or are they more likely the result of irreversible decline?
- To what extent are the financial difficulties the result of factors which are beyond the control of the directors? If they are beyond the control of the directors, are these factors likely to change?
- Can the company's liabilities be reduced over a reasonable period of time? Or will interest on debt simply cause the company to be in even further debt?
- Can key contracts with creditors be re-negotiated on better terms? Would a restructure be more successful through external administration?

2. Explanatory Memorandum 1.84, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), **https://www.legislation.gov.au/Details/C2017B00100/Explanatory%20Memorandum/Text**, (accessed 14 September 2020).

What is 'reasonably likely' to lead to a better outcome?

To ensure that the safe harbour continues to apply to any new debts which are incurred, directors will likely need to continuously assess whether the course of action they have undertaken is, and remains, 'reasonably likely' to lead to a better outcome.

The test involves an objective assessment of the course of action.

If a board of company directors hopes to rely on the safe harbour and trades while insolvent, directors will likely need to ensure that there is evidence indicating a likelihood that their course of action would lead to a better outcome.

The legislation provides some guidance regarding what is expected of directors when seeking to rely on the safe harbour, and what evidence might be required if directors are called to defend themselves in court.[3] Individual directors will likely be expected to:

a. properly inform themselves of the company's financial position;
b. take appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts;
c. take appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company;
d. obtain advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; and
e. develop or implement a plan for restructuring the company to improve its financial position.

These factors are a guide, and it is likely to be critical that the directors continue to monitor the performance of the company, and the viability of the course of action adopted, with a view to ensuring that it is still reasonably likely to lead to a better outcome or, if that is not possible, place the company into voluntary administration.

How long will the safe harbour protect me?

The safe harbour will apply to a director until:[4]

- the person or company stops taking the course of action;
- the person fails to take the course of action within a reasonable period after they start developing the course of action;
- the course of action stops being reasonably likely to lead to a better outcome; or
- the company goes into administration or liquidation.

This means that a safe harbour may be available to a director for a significant period of time. For example, if a course of action encompasses a significant debt restructure which involved numerous phase-gates over many months if not years, it is possible that the safe harbour could extend for that entire period.

What debts are included in the safe harbour protection?

The safe harbour protection does not apply to all debts. It only applies to debts which are incurred directly or indirectly in connection with developing and taking the course of action. This includes ordinary trade debts incurred in the usual course of the business, and debts taken on for the specific purpose of affecting a restructure as part of that course.

Given possible uncertainty regarding the connection between the course of action and the debt, directors should be alert to the question and ensure that there is a defensible connection. New debts which are incurred subsequent to the commencement of the implementation of a course of action will need to be scrutinised to ensure they can still be said to be connected with the course of action, or are a necessary step towards the achievement of the course of action.

3. Corporations Act 2001, s 588GA(2).
4. Corporations Act 2001, s 588GA(1)(b).

What advice do I need and from whom should I get it?

One of the important steps to take in achieving the protection of the safe harbour is obtaining "appropriate advice from an appropriate qualified entity".[5]

While obtaining advice is not mandatory to gain the protection of the safe harbour, directors should proceed on the assumption that it will be extremely difficult to provide convincing evidence to a court that a course of action was going to result in a better outcome for the company without being able to point to some form of advice which was obtained from an appropriately qualified entity.

The legislation does not define what is appropriate advice. Directors should take a critical perspective and:

- scrutinise the underlying assumptions relied upon in the advice to ensure that the conclusions are sound;
- test the conclusions of the advice with regard to the various risks, particularly risks which relate to prevailing economic conditions;
- if possible, obtain an alternative opinion from another adviser; and
- ensure that the adviser is appropriate qualified.

In terms of who is appropriately qualified to advise, the Explanatory Memorandum does provide guidance.[6] In appointing an adviser, directors should consider:

- the nature, size, complexity and financial position of the business to be restructured;
- the adviser's independence, professional qualifications, good standing and membership of appropriate professional bodies (or in the case of an advising entity, those of its people);
- the adviser's experience, qualifications and professional membership; and
- whether the adviser has adequate levels of professional indemnity insurance to cover the advice being given.

In other words, the right adviser to engage will depend on the underlying issues contributing to the financial distress of the organisation, as well as the size and complexity of the business and the extent to which it has progressed towards insolvency.

What evidence will I be expected to provide?

A director relying on safe harbour protection bears the 'evidentiary burden' to demonstrate why the ordinary insolvent trading liability provisions in s 588G(2) should not apply in legal proceedings. This means they would be expected to raise evidence that was sufficient to suggest that the facts relied on for the defence exist.

Importantly, our interpretation of the legislation is that directors are not required to prove that their course of action was reasonably likely to lead to a better outcome. Once they have provided sufficient evidence suggesting a reasonable possibility that a fact exists or does not exist, the onus shifts to the other party in the proceedings to demonstrate why the safe harbour should not apply.

Having said this, it would be prudent for directors to ensure that a course of action taken is adequately recorded. Directors should consider documenting the following at the time the course of action is being developed, and before any significant new debts are incurred by the company:

- A turnaround or restructuring plan that contains the strategies that will cause the company to be in a better position than its current state. This might simply document, for instance, a plan of negotiations with creditors to obtain better terms, which would be impossible if the company had to be placed into immediate liquidation or administration.
- A business review document that contains a detailed consideration of the company's current situation, and the way in which the proposed course of action will impact the company's financial position, shareholders and stakeholders, and creditors. This advice should also include a SWAT analysis, and a consideration of the merits and drawbacks of both the proposed course of action and the immediate appointment of a liquidator or administrator.
- Advice obtained from an appropriately qualified entity. If the advice is provided to the company informally, processes must be put in place to document this so there is an adequate record of the advice obtained.

5. Corporations Act 2001, s 588GA(2)(d).
6. Explanatory Memorandum 16-19.

What employment and tax thresholds must be met to rely on the safe harbour?

The safe harbour legislation contains certain safeguards that are designed to protect the interests of employees and promote compliance with tax reporting obligations. Before incurring any new debt, directors will need to take steps to satisfy themselves that employee entitlements have been paid and will continue to be paid, and tax reporting obligations have been met and will continue to be met.

This is likely to be critically important because for the period where a company is non-compliant with these obligations, the safe harbour will not apply in relation to any debts incurred during the period the company is non-compliant. Directors could therefore be exposed to significant personal liability should these matters not be addressed.

Employee entitlements

Employee entitlements include wages, superannuation, injury compensation, leave of absence entitlements under an industrial instrument and retrenchment payments payable under an industrial instrument (s 596AA(2) of the Corporations Act).

Tax reporting obligations

Directors should ensure that the company has lodged all tax reporting documents, including Business Activity Statements, company tax returns, any fringe benefit tax returns, and so forth. It does not require up-to-date payment to the ATO, only that reporting itself is up to date.

When does the safe harbour apply to holding companies when a subsidiary is in danger of trading while insolvent?

Section 588WA provides that a holding company will not be liable for insolvent trading under s 588V to compensate creditors of its subsidiary for losses that arise as a result of debts incurred by the subsidiary if:

- the corporation takes reasonable steps to ensure that the safe harbour applies to each of the directors and the debt of the subsidiary company in question; and
- the safe harbour does apply in relation to the directors of the subsidiary company.

It is not clear what reasonable steps would be required to ensure that the safe harbour is available to the directors and the debt of the subsidiary. However, it is likely that this section requires the directors of the holding company to take positive actions to ensure that the directors of the subsidiary can avail themselves of the safe harbour protection.

What if I am a director of a subsidiary company?

While the safe harbour does apply to subsidiary directors as a general principle, it is important to note that a subsidiary director who enables the subsidiary to incur further debts while insolvent – where this course of action will only provide a benefit to the holding company or the corporate group at the expense of the subsidiary – will not be entitled to the safe harbour defence. The safe harbour requires directors to develop and implement a course of action that will lead to a better outcome for the company they direct, and not its corporate group. The exception to this is if the company is a holding company (see above).

Does the safe harbour apply to not-for-profit companies and charities? What about incorporated associations?

The safe harbour applies to any director of a company which is subject to the insolvency provisions of the Corporations Act. For this reason, the safe harbour applies to companies limited by guarantee, including those registered with the Australian Charities and Not-For-Profits Commission (ACNC). Incorporated associations that are registered with the ACNC may also be entitled to safe harbour protection. This will depend on the provisions of the specific state or territory legislation under which the entity is incorporated. ACNC-registered incorporated associations should seek legal advice in this regard.

> The ACNC confirms that the temporary insolvent trading safe harbour will extend to directors of not-for-profits and all charities (not just those that operate as companies limited by guarantee), provided charities (i) have an achievable aim to return to viability once the crisis has passed and (ii) inform members and the ACNC if trading insolvent.

It is not clear, however, whether committee members of incorporated associations (which are regulated separately in each state and territory) are afforded the same relief.

What happens if the company is placed into formal insolvency after a period of safe harbour?

If the company enters formal insolvency processes, it is essential that directors comply with obligations relating to assisting and providing materials to a liquidator, administrator or controller, as required.

If a liquidator, administrator or controller is denied access to a company's books or information about a company, a director will not be able to later use these books or information to support a safe harbour defence. This restriction does not apply to directors if they prove they did not possess the relevant books or information, and there were no reasonable steps that could have been taken to obtain the materials.

In addition, the safe harbour will not be taken to have been available if a director fails to substantially comply with their obligations to provide assistance or information to an administrator, liquidator, or controller in a formal insolvency under ss 429(2)(b), 475(1), 497(4), or 530A(1) of the Corporations Act.[7]

Does the safe harbour apply to the board collectively?

The safe harbour applies to each individual director. For this reason, each director needs to take personally responsibility to ensure that they are satisfied that any course of action is reasonably likely to lead to a better outcome, and all the other preconditions for the safe harbour protections are being met, prior to taking the step of incurring debts while insolvent or approaching insolvency.

7. Corporations Act 2001, s 588GA(5).

ASX guidance on safe harbour

ASX Guidance Note 8 contains commentary with respect to the need to disclose an intention to rely on the safe harbour:

> "[The] ASX has been asked whether the fact that the entity's directors are relying on the insolvent trading safe harbour in section 588GA of the Corporations Act requires disclosure to the market. Section 588GA is a conditional carve-out from a director's potential liability for insolvent trading that does not affect an entity's continuous disclosure obligations or reduce the entity's obligation to disclose the extent of its financial difficulties. The fact that an entity's directors are relying on the insolvent trading safe harbour to develop a course of action that may lead to a better outcome for the entity than an insolvent administration, in and of itself, is not something that ASX would generally require an entity to disclose under Listing Rule 3.1. Most investors would expect directors of an entity in financial difficulty to be considering whether there is a better alternative for the entity and its stakeholders than an insolvent administration. The fact that they are doing so is not likely to require disclosure unless it ceases to be confidential or a definitive course of action has been determined."

Guidance Note 8 makes clear, however, that if there is an adverse development affecting the financial condition or prospects of an entity that falls outside the carve-outs to immediate disclosure in Listing Rule 3.1A, and a reasonable person would expect information about that development to have a material effect on the price or value of its securities, the entity must immediately disclose that information under Listing Rule 3.1.

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